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UNCLAS SECTION 01 OF 03 STOCKHOLM 000701

TREASURY FOR DAVID WRIGHT

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SIPDIS

C O R R E C T E D C O P Y (clarification in para 6.)

E.O. 12958: N/A
TAGS: EFIN PREL ECON SW
SUBJECT: SWEDISH BANKING SECTOR STABLE, BUT CHALLENGES REMAIN

STOCKHOLM 00000701 001.2 OF 003

¶1. Summary: All four major Swedish banks continued to see deteriorations to their credit portfolios in the third quarter primarily as a result of exposure to the Baltic region and Ukraine, but signs of improvement appeared in the form of decelerating credit losses. Market commentators continued to express confidence in the stability of the Swedish banking sector, but also noted that significant challenges remain in the form of sizeable credit losses. Swedbank and SEB especially remain at the risk of accelerating credit losses as a result currency devaluation in the Baltic region. With its decision to keep the benchmark rate flat and extend additional loans, the central bank recognized that the situation on financial markets, while much improved, has not returned to pre-crisis levels. Amid concerns of a housing bubble, the Central Bank Governor has warned that rising housing prices are not sustainable, and called on households and banks to plan for interest rates to rise over the long run. End Summary

Swedbank Losses Up but Credit Losses Decelerate
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¶2. Swedbank on 20 October was the first to report third quarter results, which included a before tax loss of SEK 2.582 billion ($369.1 million), an increase of SEK 733 million ($104.8 million)in losses from the previous quarter primarily due to continued large loan loss provisions in the Ukraine, Latvia, and Lithuania. The loss is in stark contrast to the SEK 3.113 ($445.1 million) in profits from a year ago. Despite the worse than expected loss, Swedbank's CEO Michael Wolf expressed optimism as credit losses in the Baltic region are no longer worsening at the same pace as before. Credit losses in the Baltic region decreased from net SEK 4.0 billion ($572 million) in the second quarter to SEK 3.3 billion ($469 million). Latvia registered the highest ratio of impaired loans at 19.74 percent, followed by Lithuania (12.33 percent), and Estonia (6.42 percent). According to reports in Stockholm Daily Svenska Dagbladet, Swedbank expects to seize and administer property in the Baltic region worth SEK 5 - 15 billion ($0.715 - 2.145 billion) between now and 2011 through its newly formed Swedbank subsidiary Ektornet. Swedebank's year-to-date loan losses in the Baltic region amount to SEK 11.5 billion ($1.6 billion) and gross total impaired loans amounted to SEK 26 billion ($3.72 billion) vs. SEK 7 billion ($1 billion) at the end of 2008.

¶3. Swedbank's share of impaired loans in Ukraine increased to 43 percent as of 30 September, compared with 5 per cent at the start of the year as a result of a large depreciation of the Ukrainian currency increasing the loan payment burden for many Ukrainians with foreign currency denominated loans. Impaired losses stood at SEK 6.2 billion ($887 million) since the beginning of 2009 until September.

¶4. Swedbank continues to profit from its Swedish operations.

Working profits increased by 8 percent to SEK 2 billion ($268 million) in comparison to the same period last year. Another positive improvement is the decrease in the share of impaired loans in Sweden from 0.23 percent in the second quarter to 0.05 percent in the third quarter.

SEB Bottom Line Improves but Falls Short of Last Year
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¶5. Rival SEB's third quarter report revealed a plummeting operating profit and continued provisions for credit losses, primarily in the Baltic region and Russia. Operating profit in the third quarter plummeted by 85 percent compared to the previous year, but after tax the profit margin improved from a second quarter loss of SEK 174 million($24.9 million), primarily the result of SEK 2.394 billion ($340.9 million) in impairment charges related to SEB's investments in Eastern Europe, to SEK 37 million ($5.3 million). Lithuania is currently the largest risk country for SEB, its credit losses there total almost SEK 1.5 billion ($213.6 million) whereas credit losses in Latvia and Estonia combined only total SEK 1.15 billion ($163.9 million). Provisions for the Baltic region amounted to SEK 2.642 billion ($376.7 million) or 79 percent of the group's total. Credit loss provision continued to increase in Lithuania and Latvia, but have decreased in Estonia in comparison to the previous quarter. SEB's CEO Annika Falkengren also announced that SEB will not apply for an extension of the state guarantee program, which is to end on 31 October) and stressed that SEB has not previously taken advantage of the program.

Nordea and Handelsbanken Beat Expectations

¶6. Nordea and Handelsbanken reported better than expected results due to a jump in earnings from basic lending operations and lower loan loss provisions despite registering shrinking profit margins. Nordea's operating profit of EUR 832 million ($1.236 billion) was up by 2 percent, but down by 2 percent when compared to the same period

last year. Impaired loans, mainly related to Denmark and the Baltic region, increased to EUR 3.851 billion ($5.721 billion), up by 9 percent compared to the second quarter, but showed signs of stabilization. In the two previous quarters, the increases were 19% and 33% respectively. The provisioning ratio increased from 49 percent in the second quarter to 51 percent. In the Baltic countries, gross impaired loans amounted to EUR 522 million ($776 million) or 7.05 percent of total loans, compared with EUR 418 million ($621.4 million) or 5.5 percent at the end of the second quarter. The increase in impaired loans was 25 percent from the previous quarter, compared to a growth rate in the second quarter of 63 percent. Handelsbanken reported an operating profit of SEK 3.255 billion ($464.3 million) down by 6 percent compared to the second quarter and 13 percent when compared to the same period in the previous year. With zero exposure to the Baltic region or Ukraine, the level of impaired loans decreased from SEK 4.385 billion ($625.1 million) in the second quarter to SEK 3.710 billion ($528.9 million) in the third quarter or 0.24 percent of all lending. Overall loan losses increased in all of Handelsbanken's areas of operation, except for Finland, with the most dramatic increase in the UK.

Market and Media Reactions
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¶7. The banks' third quarter results caused mixed reactions in the stock market. While Swedbank's stock remained unchanged following the announcement of the loss and Nordea's increased by 2.8 percent, SEB and Handelsbanken's stock lost 4 percent and 4.3 percent, respectively, on the day of the announcement. Since the beginning of the year, stocks of the four banks, however, have well outperformed the OMX Nordic 40 index that tracks the 40 largest and most actively traded stocks on the Nordic exchange. Year-to-date figures also suggest investor confidence in the banks' future position in the Nordic market; their stock price increased by at least 42 percent (SEB), with Nordea registering the largest gain with 73 percent.

¶8. Several commentators pointed out that Swedbank's situation is much better now than at the beginning of the year. The bank is well capitalized, and the trend of increasing credit losses seems to have

been broken. The report was further positively received as it tells about the very low level of credit losses in the Swedish operations. This further reinforces the message that the banks have tried to convey, that the banks have managed to handle credit losses much better this time than they did during the previous, domestic, banking crisis in the early nineties. Jan Almgren, Columnist and analyst at Stockholm Daily adopts a more cautious approach summarizing Swedbank's report "as bad as expected and then some". Although not all results were worse than expected he advises against premature celebrations, with 7 billion in losses this year alone, "Swedbank has a long and winding road ahead" Almgren writes. Overall, as the Swedbank report is published only days after Swedbank's Estonian pension-scandals, the general view among analysts and media reports is that Swedbank has now hit bottom.

¶9. SEB's results have been less anticipated because it has generally performed better than Swedbank and has a smaller exposure to the Baltic region. According to Andreas Cervenka at SVD "the 'Wallenberg bank' stands on solid ground." Considerations of employee bonuses, however, are likely to draw widespread criticism in the future as the bank will have the opportunity to again reinstate the bonus system once it sheds the state guarantee program. Already talks of raising the CEO's salary as a result of her giving up her bonus earlier this year caused quite a stir. Currently SEB has allocated SEK 1.5 billion to employee bonuses.

Riskbank Keeps Rates Flat, Provides Additional Liquidity

¶10. Sweden's central bank, the Riksbank, on 23 October kept the benchmark interest rate (repo) unchanged at 0.25 percent and announced its decision to extend new loans amounting to SEK 100 billion ($14.7 billion) to the country's banks to ensure sufficient liquidity in the market. (The loan auction was held on November 2 and the final amount lent was SEK 95.3 billion.) The loans are at a fixed interest rate and with a maturity of 11 months and "should contribute to continued lower interest rates on loans to companies and households," the Riksbank said. The central bank justified its decision by noting that while the situation on financial markets was much improved, it had not yet returned to pre-crisis levels. On November 5, Riksbank Governor Stefan Ingves told the Parliament Finance Committee that the Riksbank currently expected to hold the repo rate unchanged at a low level until autumn 2010 in order to contribute to a stable economic recovery and attain the inflation target of 2 percent.

¶11. Reactions to the Riksbank decision have been mixed. The decision to keep the interest rate at 0.25 percent was expected but

most analysts were surprised by the loan offer. Nordea's chief economist Annika Winsth calls the action both "unexpected and unnecessary". Cecilia Skingsley, Chief analyst at Swedbank, is also surprised but maintains that a new loan always was a possibility. All leading Swedish banks believe that the benchmark interest rate will be raised sooner than the Riksbank projection of 4th quarter of ¶2010.

A housing bubble in the making?

¶12. Much speculation in Sweden surrounds whether a housing bubble is in the making. With an interest rate of close to zero percent both demand and prices are up. Mortgage applications are up 15 percent for condominiums and 8 percent for houses compared to the same period in 2008. Even the Riksbank noted in its report that the current housing-prices are "above a level that is sustainable in the long-term." In his speech to the Parliamentary Committee on Finance, Ingves explained that the Riksbank cannot adapt monetary policy on the basis of individual markets unless they threaten the inflation target or financial stability. Ingves reiterated that it is "hardly sustainable" for housing prices to continue their rise of around 8 percent a year since 1996. Since lending and housing prices are largely beyond the Riksbank control, he said, it is important for households to make realistic calculations, and banks to make responsible credit assessments since interest rates will rise in the long-run. He noted that the Swedish Financial Supervisory Authority "is prepared to take action if they consider it necessary."

Comment

¶13. Although Baltic investments remain a problem for Swedbank and SEB, there is little fear in Sweden that their losses there will significantly affect the Swedish market. The fact that Swedbank's total losses were larger than expected was viewed as less important than the decelerating trend in expected credit losses, offering hope that the worst could be over in the troubled Baltic region. Both Swedbank and SEB have lifted their core tier one capital ratio to 12.3 percent and 11.8 percent, respectively,--among the highest in Europe, and have the backing of the state guarantee program if necessary.

¶14. The staggering absolute level of losses in Eastern European operations, however, could require recapitalization of subsidiaries in the future. Political risks in Latvia and Ukraine, combined with a sharp economic downturn, remain high and credit losses could quickly accelerate if Latvia is forced to devalue. While Swedbank's chief risk officer, Goran Bronner, sought to reassure investors and shareholders that the bank could absorb a 15 percent controlled devaluation in Latvia, a larger devaluation combined with investor concern about the Baltic region as a whole-a devaluation in Latvia would put pressure on neighboring Estonia and Lithuania to devalue-could result in a confidence crisis and a setback for the recovery of the Swedish banking sector. End comment.

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